

Economics Education and Research Consortium

Working Paper Series

ISSN 1561-2422



No 06/04

Relative property rights in transition economies

Can the oligarchs be productive?

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This project (No. 02-059) was supported
by the Economics Education and Research Consortium

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Research area: **Enterprises and Product Markets**

JEL Classification: C23, C33, C78, D82, K11, L61

GRYGORENKO Y.N., GORODNICHENKO Y.A., OSTANIN D.V. Relative property rights in transition economies: Can the oligarchs be productive? — Moscow: EERC, 2006.

Empirical evidence suggests that Ukrainian ferrous metal industry exhibits extremely low capacity utilization rates. This project seeks to explain this phenomenon within the framework of the property rights approach. A solution to the problem is proposed via introduction of the third party between primary producing firms. Policy implications will be developed.

Keywords. Ukraine, ferrous metal industry.

Acknowledgements. I thank Gary Krueger and Mark Shaffer for valuable comments and recommendations.

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1. INTRODUCTION

Since the seminal papers by Ronald Coase (1937, 1960) property rights are taken seriously in economics. Literally thousands of papers have been written to investigate the effects of property rights allocation on economic outcomes with most empirical research using data from the developed economies. Yet, it is the transition economies that provide the clearest picture of why and how property rights can affect economic outcomes. Their unique natural experiment highlights how patterns of property rights evolve from the inefficient forms inherited from the communist past to the more efficient forms induced by the market and reveals which forms are the most efficient and viable. Indeed, the literature devoted to analyzing and quantifying the impact of property rights allocation and security on the behavior and performance of enterprises in transition and emerging market economies has grown considerably over the last several years.¹

In this paper, we examine how ownership affects enterprise performance, focusing on how oligarchs — the politically and economically strong conglomerates — affect the firms they own. It is commonly believed that enterprises captured by oligarchs tend to perform poorly (*e.g.* Stiglitz 1999, Black and Tarassova 2002). We examine this widely shared belief and show, both empirically and theoretically, that the presence of oligarchs can enhance the relative performance of enterprises.

Building on the ideas of Grossman, Hart, and Moore (Grossman and Hart 1986, Hart and Moore 1990, Hart 1995), we show in a theoretical model that the evolution of property rights allocation towards integrated conglomerates led by oligarchs is not necessarily bad. We argue that oligarchs reduced adverse effects of disorganization at the early stages of transition by reintegrating production chains to the market efficient levels. Our model explains several key stylized facts about the behavior of oligarchs that are both observed in the data and commonly reported in business press. We thereby show that these behavioral patterns are the outcomes of rational optimizing choice of oligarchs

Our empirical results, based on a sample of almost 2000 Ukrainian open joint stock companies, suggest that oligarchs tend to improve the relative performance of enterprises they own. Importantly, in contrast to previous studies of business groups, we control for endogeneity of firm ownership. Our findings have important policy implications for Ukraine and other countries with similar institutions (*e.g.*, Russia) or similar organization of property rights (*e.g.*, South East Asian and Latin American countries with highly concentrated economic and political power).

We start the paper with a brief description of the theoretical model. Next, we present our main theoretical results and show how they fit into the literature and experience of transition countries. In Section 3, we discuss our data and present an empirical test of the model. We conclude in Section 4.

¹ See for example Khanna and Rivkin (2001), Johnson, McMillan, and Woodruff (2002), Kocenda and Svejnar (2003), Samphantharak (2003) — these are the works that focus on examining effects of property/residual control rights on performance. References to other noteworthy relevant works can be found in Djankov and Murrell (2002).

2. WHY CAN OLIGARCHS BE PRODUCTIVE?

2.1. GHM approach and oligarchs

There is a wealth of evidence that the allocation of property rights critically matters for economic performance. Approaching our research from this perspective, we anchor it within the framework of the Grossman–Hart–Moore (GHM) model.² The fundamental idea in the GHM model is that in the world of incomplete contracts, distribution of property rights over the set of physical assets has an impact on production and investment incentives of the agents that work with those assets. The logic of this idea is as follows.

If we view a firm as a link in an end-to-end production cycle, we would expect it to interact systematically with counterparties up or down the production chain. The interaction may take form of an open-market competitive bargaining for contracts, which can be efficient only in the absence of significant information asymmetry regarding product qualities and delivery terms, or it may boil down to a short list of trusted long-run partners. In many, if not most, industries, the second form prevails, as it allows all the parties along the chain to lower transaction costs associated with producing and marketing the product by minimizing search costs, quality control expenses, warranties, etc. Moreover, in this setup direct production costs can be lowered, as firms invest in relationship-specific physical and human capital (see Hart 1995, de Meza and Lockwood 1998) without taking on a considerable risk of being "help up" — *i.e.*, more certainty implies less cost. As pointed out by Klein, Crawford, and Alchian (1978), such relationships offer a potentially beneficial opportunity for vertical integration of the whole production chain under a single owner's umbrella.³

If firms do not have the political and economic resources to integrate downstream or upstream firms,⁴ it is only third parties endowed with sufficient power and resources that can integrate firms along a production chain into a conglomerate when this is warranted by the GMH argument. Oligarchs, formed in Russia, Ukraine and other transition economies in mid-1990s,⁵ clearly had re-

² The GHM model in the nutshell can be found in Hart (1995) and some of its modifications in Hart and Moore (1990); de Meza and Lockwood (1998). A firm in the view of this approach is nothing more than a collection of the assets that it owns (Grossman and Hart, 1986). Ownership itself is determined as "possession of residual control rights over the asset: the right to decide all usages of the asset in any way not inconsistent with a prior contract, custom, or law" (Hart, 1995).

³ Hart (1995), however, emphasizes that integration is likely to involve some costs as well. In particular, it is obvious that integration would involve alienating residual control rights over productive assets from some of the firms and transferring them to a single owner.

⁴ This appears to be the case for vast majority of firms in transition economies including Ukraine. Documented liquidity constraints (*e.g.*, Pissarides, Singer and Svejnar, 2003), explosion of barter transactions and all sorts of arrears (*e.g.*, Marin and Schnitzer, 2002) indicate that firms face significant constraints to finance any form of integration.

⁵ Mass privatization and lax legislation created favorable conditions for concentration of ownership in few hands. However, explaining the origins of oligarchs is beyond the scope of this paper. We refer the reader to Pappe (2000), Freeland (2000) and Hoffman (2002) who describe the emergence of oligarchs in Russia. Readers with a good command of Russian and Ukrainian language may find interesting information on background of Ukrainian oligarchs in Investgazeta (2003), Bondarenko (2000, 2003) and Orlov (2002).

sources to overcome various barriers to integration of production chains and to convert potential integration synergies into profits (*e.g.*, enforce contracts). Once firms are integrated, they achieve higher efficiency because oligarchs have incentives to make relation-specific investments that generate surplus that is not available to these firms in the absence of integration. The distribution of the surplus can be, however, highly uneven. Oligarchs can expropriate a disproportionately large share at the expense of other parties such as employees and the government. Looting firms, which gives such bad press to oligarchs, is one of the channels how this expropriation can happen.

This logic suggests that oligarchs, however demonized they are, may be socially beneficial. Olson (2000) gives a famous example of stationary bandits in the medieval China. Indeed, those bandits were unpleasant governors but as long as they had shares in profits from economic activity they enforced contracts, protected trade, and facilitated production. Thus, encompassing incentives can transform robber barons into benevolent rulers.

Before proceeding to the formal model, we must analyze the behavior of oligarchs and try to uncover some regularities in the latter that would help us to anchor our model in the reality. Business press and popular media have been full of reports on the financial-industrial groups (FIGs), their emergence and development since late 90s (naturally, Russian oligarchs were first to attract public opinion, their Ukrainian counterparts joined the scene 2–3 years later). After processing this mass of quasi-anecdotal evidence, we formed the following list of stylized facts about economic behavior of oligarchs:

- 1) Oligarchs tend to choose large, not necessarily productive firms.
- 2) In other words, initially oligarchs seek out large cash generating vehicles, without regard for enterprise efficiency and profitability. As Hoffman (2002, p. 285) puts it speaking about Boris Beresovsky, one of the odious Russian oligarchs, "... the first thing he wanted to take in a company was its cash flow, and only later he would be interested in owning it". Another rationale for aiming at "big names" was the political influence that could be purchased alongside with the shares.
- 3) Oligarchs tend to create vertically integrated production chains.
- 4) Visual inspection of FIG schemes that can be found in Investgazeta (2003, 2004) reveals that most of the groups comprise mostly enterprises, which serve as suppliers or consumers to each other. The simplified structure of a typical oligarchic group, "Pryvat" is given in Appendix.
- 5) Oligarchs can own relatively "unprofitable" firms.
- 6) Here we mean accounting profits rather than true economic value added generated by the firm. For instance, power distribution in Ukraine is almost wholly controlled by the very few FIGs — the "Dynamo" group holds stake in ten regional power distributing utilities, "Finance and Credit" group controls another two, ISD and "Energo" groups from Donetsk are also reported to have an interest in the industry (Investgazeta (2003, 2004), Bondarenko (2003). Meanwhile, most of regional power distributors have consistently reported losses in 1999–2003.
- 7) Oligarchs often invest in improving productivity of firms they own.

- 8) This observation is, probably, the most controversial. For instance, in Ukraine most of the increase in capital expenditures by oligarchs has been reported in the steel industry. There is no consensus whether this was a result of efficient management or mere consequence of cash flow boost provided by the so called "economic experiment", which significantly lowered income tax rate for integrated steel plants. However, Perotti and Gelfer (2001) provide some evidence that Russian oligarchs were probably more efficient in their real investments than independent owners in mid-90s.
- 9) In the early stages of transition, firm looting appears to be particularly severe.
- 10) Hoffman (2002, p. 500) presents this observation as follows, "... as the oligarchs gained more and more control over their companies, they became better stewards out of sheer self-interest. In the 1990s they fought bitter fights to gain majority ownership; now that it was all theirs, they were more inclined to treat the company nicely."
- 11) Oligarchs almost invariably own foreign, typically off-shore companies.
- 12) The list of such companies for some of Ukrainian FIGs can also be found in Investgazeta (2003, 2004) and Bondarenko (2003). Relevant comment on Russian oligarchs is provided by Hoffman (2002, pp. 446–447), "Khodorkovsky (one of the Russian oligarchs) built an off-shore financial network. Menatep (the core of Khodorkovsky's group) branched out to off-shore havens in Switzerland, Gibraltar, the Caribbean, and other secretive locations where hundreds of millions of dollars could be easily hidden... Khodorkovsky's far-reaching off-shore network was typical for Russian big business. All other oligarchs did the same thing."

We put together and formalize all these ideas and observations in the following section.

2.2. Model

Firm ownership gives control over key decisions: how to price goods, allocate profits, choose customers and suppliers, etc. Often, there is nothing criminal in transferring resources from one firm to another, and legal and illegal practices are competing ways to run a business (Johnson *et al.*, 2000). For example, transfer pricing can be a legal form of shifting resources from firm A to firm B, though perhaps at the expense of firm A's shareholders, workers and local government. Anecdotal evidence from Ukrainian and Russian firms owned by oligarchs suggests that transfer pricing in various guises (*e.g.*, overstated costs, understated sales) is a good description of how resources are tunneled away from firms.⁶ Hence, we focus on this form of looting.

⁶ Hoffman (2002, p. 301) describes one of such schemes, "A common technique was called "transfer pricing". An extraction company sold oil to another company at an artificially low price, say, \$2 per barrel. The second company then sold it for export abroad at a much higher price, say \$18 per barrel. The result was that the extraction company, with all the drills, wells, fields, and workers, lost money, while the second company made a handsome profit. The wealth was transferred from one company to another, often in secret using shell companies and off-shore havens." In Ukraine, this practice was widespread and openly used in late 90s in the steel industry. Under the Law of Ukraine *On Conduct of Economic Experiment at the Enterprises of the Mining and Metals Industry of Ukraine* (1999), integrated steel works faced a 9% (later 15%) income tax rate against a 30% standard rate. Naturally, FIGs transferred profits from the enterprises up the chain (coke, energy, coal, *etc.*) to the integrated plants in order to optimize their tax budgets.

To fix the ideas, suppose that the oligarch has the following benefit function:

$$B_i = \delta S_i + (1 - \tau)((1 - \delta)S_i - C_i) - f(\delta - a_i/(1 + a_i)) - 1_{\delta > 0} \phi, \quad (1)$$

where i indexes firms, S_i is the volume of sales, C_i is the cost of produced output, τ is the profit tax rate, δ is the degree of looting (or transfer pricing), the function $f(\cdot)$ measures penalty for looting firms, a_i is the markup (equivalently, productive efficiency or profit margin) parameter, ϕ is the fixed fee of being engaged in looting and $1_{\delta > 0}$ is the indicator function equal to one if $\delta > 0$ and zero otherwise. To simplify the argument, we assume that the parameters S_i , C_i and a_i are exogenously given to firm i and $(1 + a_i)C_i = S_i$. Finally, we assume that the penalty function f is convex and strictly increasing in the looting parameter δ . In addition, the penalty is zero at $\delta = 0$ and infinity at

$$\delta = a_i/(1 + a_i).^7$$

Formally,

$$f(-a_i/(1 + a_i)) = 0, f' > 0, f'' > 0 \text{ and } \lim_{\delta \rightarrow a_i/(1 + a_i)} f(\delta - a_i/(1 + a_i)) = +\infty.$$

Under these assumptions, B_i is strictly concave in δ .

Let us analyze and interpret the benefit function in (1). If the oligarch is transparent, *i.e.*, $\delta = 0$, his benefit of owning firm i collapses to after-tax profit: $B_i = (1 - \tau)a_i C_i$. Alternatively, the oligarch can transfer resources from firm i by decreasing the value but not the physical volume of sales. Put differently, the books of firm i record only $(1 - \delta)S_i$ sales and the first term, δS_i , in (1) is the revenue of the oligarch's firm in a tax haven, which we assume to have a zero tax rate on profit.⁸ Accordingly, the book before-tax profit of firm i decreases from $a_i C_i$ to $((1 - \delta)(1 + a_i) - 1)C_i$.⁹ This transfer of resources is costly as the looting oligarch incurs a flow cost

$$f\left(\delta - \frac{a_i}{1 + a_i}\right)$$

(*e.g.*, a bribe to officials) and a quasi-fixed fee ϕ (*e.g.*, flow cost of running an unproductive off-shore company to transfer resources to). Optimal looting behavior δ_i^* maximizes B_i and satisfies the

⁷ Clearly, in the long-run an oligarch cannot loot more from the firm than the cumulative stream of its profits, otherwise the firm would have gone bankrupt. Therefore, in the long run, maximum looting is limited to gross profit.

⁸ Tax havens can be domestic: charities, free economic zones, sports and social ventures, etc. For instance, the oligarchic group "Dynamo" has used football club "Dynamo Kyiv" as its tax shelter. See *The Loophole Economy* chapter in Freeland (2000) for eloquent examples from Russia.

⁹ In the model presented above we assume that looting goes through understating sales. It is an easy exercise to show that the same conclusions emerge if looting is going through overstating costs.

following first order condition:

$$\delta_i^* = \frac{a_i}{1+a_i} + f'^{-1}(\tau(1+a_i)C_i) = \frac{a_i}{1+a_i} + f'^{-1}(\tau S_i) > 0, \quad (2)$$

and the benefit from the optimal looting is

$$\begin{aligned} B_i^{*O} &= (1-\tau)a_i C_i + \delta_i^* S_i \tau - f(\delta_i^* - a_i/(1+a_i)) - \phi = \\ &= (1-\tau)\frac{a_i}{1+a_i} S_i + \delta_i^* S_i \tau - f(\delta_i^* - a_i/(1+a_i)) - \phi. \end{aligned} \quad (3)$$

This outcome is compared to the fully legal (no looting, $\delta = 0$) activity

$$B_i^{*L} = (1-\tau)a_i C_i = (1-\tau)\frac{a_i}{1+a_i} S_i.$$

The optimizing oligarch then chooses $\delta^* > 0$ if

$$\Delta B_i \equiv B_i^{*O} - B_i^{*L} = \tau S_i \delta_i^* - f(\delta_i^* - a_i/(1+a_i)) - \phi > 0. \quad (4)$$

Note that the oligarch's decision to run an off-shore company is a rational endogenous response to tax differentials across countries. Therefore, the model can explain the stylized fact #6.

Given these definitions and assumptions, we can prove the following proposition.

Proposition 1.

Optimal looting has the following properties:

1. $\delta_i^* \in [0, a_i/(1+a_i))$.
2. $\partial \delta^* / \partial a_i > 0$.
3. $\partial \delta^* / \partial S_i > 0$.
4. The probability of looting is decreasing in the fixed penalty ϕ and flow penalty $f(\cdot)$.
5. Looting is increasing in the profit tax rate τ , i.e. $\partial \delta^* / \partial \tau > 0$.

Proof: see Appendix.

Intuitively, the first three results state that 1) optimal looting is bounded by the firm's profit margin a_i , 2) the larger the profit margin a_i , the less noticeable is the transfer of resources and 3) the larger the firm, the larger is the gain from transferring a fixed percent of sales. These results are important in determining which firms are owned by oligarchs.

The last two results of the proposition suggest that in countries with a high penalty for looting firms we should observe few looting oligarchs. Likewise, transparent behavior is stimulated by low taxes.

This appears to be consistent with the experience of transition countries like Estonia and Lithuania, where taxes are low and looting is highly penalized.

The last result has another important implication. Suppose that the oligarch does not have a 100% ownership in firm i and his share in the equity is η . Then after paying taxes and dividends to other shareholders, his profit is $B_i = (1 - \tau)\eta a_i C_i$. If we define effective tax rate as $\tilde{\tau} = 1 - (1 - \tau)\eta$ so that

$$B_i = (1 - \tau)\eta a_i C_i = (1 - \tilde{\tau}) a_i C_i$$

and apply the last result of the proposition, we find that the larger the oligarch's share η in the equity, the fewer incentives he has to loot the firm. In the beginning of the transition, would-be oligarchs very rarely owned significant shares in firms and, consequently, looting was particularly acute in that period. As they accumulated wealth and shareholdings, they appear to be less aggressive. This matches the stylized fact #5.¹⁰

Next we turn to the oligarch's choice which firms to own.

Proposition 2.

- 1) Suppose that the sales of firm i are proportional to K_i , the equity capital of firm i , *i.e.*, $S_i = \kappa K_i$. Then the oligarch's return on capital is weakly increasing in the firm size measured by sales. The transparent owner's return on capital is independent of firm size.
- 2) The oligarch has a weakly higher return on capital in productive firms than the transparent owner.

Proof: see Appendix.

Intuitively, the firm size matters for oligarchs because the fixed fee and flow penalty for looting per sales is decreasing in sales. Since oligarchs have higher return on capital (ROC) in large firms, they are willing to pay a higher price for these firms. In contrast, transparent owners are indifferent between large and small firms as long as they have the same productivity. Hence, it should be the case that oligarchs tend to own large firms. This is in agreement with stylized facts #1 and #3. Indeed, utilities and power generating and distributing companies, which are often owned by oligarchs in Ukraine and Russia, are heavily regulated and their reported profits tend to be small. However, their volume of sales is immense thus giving oligarchs the incentives to acquire a stake and control these firms (recall Berezovsky's thirst for large cash flows, which are not generally related to productivity). This result is important for our empirical work when we develop a selection equation to model endogeneity of firm ownership.

¹⁰ The model can be easily extended to analyze protection of minority shareholders. For example, large ϕ and steep f can be interpreted as good protection of minority shareholders. Poor protection of minority shareholders is not confined to transition economies. See Johnson *et al.* (2000) for examples from developed economies. The model also sheds new light on transfer pricing used by multinational companies.

To understand the second part of the proposition, note from (3) and (4) that for any increase in productivity a_i and for any given the looting parameter δ the oligarch captures a direct gain in after-tax profits, receives a larger transfer to his off-shore company (because he transfers a fixed percent of sales to his off-shore company) and pays a smaller penalty for looting

$$f(\delta - a_i / (1 + a_i))$$

as the leakage becomes less noticeable.

We now generalize the model and allow firms to invest in productivity enhancing projects. We assume that each firm can undertake a cost reducing investment project and boost its productivity from a_{1i} to a_{2i} with $a_{2i} > a_{1i}$. The flow cost of the project is χC_i . Any rational owner should make the investment if it increases the profit. As the following proposition shows, oligarchs are more likely to make such an investment.

Proposition 3.

The oligarch makes (weakly) larger investments than the transparent owner.

Proof: see Appendix.

The reason why oligarchs are more willing to invest is that they have a higher return on firm size and productivity than transparent owners. Specifically, with higher productivity, oligarchs can hide tunneling more easily. Since they transfer a fixed percent of sales to off-shore companies and looting increases in productivity, for every increase in productivity they make a larger transfer of firm resources to tax havens thus avoiding high taxes at home and receiving a higher return on investment. In contrast, transparent owners have to share the gains from increased productivity with the government and thus have weaker incentives to invest. This explains stylized fact #4.

This proposition shows that oligarchs have stronger stimuli to improve firm productivity. However, understated sales and likewise overstated costs can translate into a low measured productivity. Formally, let us denote recorded sales with \tilde{S}_i and measured productivity with \tilde{a}_i . Then the measured productivity is

$$\tilde{a}_i = \frac{\tilde{S}_i - C_i}{C_i} = \frac{(1 - \delta_i^*)(1 + a_i)C_i - C_i}{C_i} = (1 - \delta_i^*)(1 + a_i) - 1. \quad (5)$$

It follows that as long as $\delta_i^* > 0$ we should observe $0 < \tilde{a}_i < a_i$. Because optimal looting δ_i^* is increasing in productivity, a genuinely productive firm owned by an oligarch may look unproductive even after a productivity enhancing investment.

In theory, the investing oligarch may be so productive that he pays more in taxes than the transparent owner who does invest. Observe that for a fixed δ , investing oligarchs generate higher profit, thus paying higher taxes. On the other hand, higher productivity leads to larger looting δ , thus decreasing the tax base. Hence, we cannot unambiguously predict if investing oligarchs will generate

higher tax revenues. If the gain in productivity is sufficiently large and looting is relatively small, the oligarch undertaking the investment project would generate more tax revenues for the government than the transparent owner.

We now turn to the oligarch's inclination to vertically integrate firms. First consider the case when there is no synergy from merging firms. There are two firms: upstream (U) and downstream (D) with productivity parameters a_U and a_D , respectively. The upstream firm sells its output to the downstream firm so that the sales of the upstream firms are equal to the costs of the downstream firm. To capture complementarity of assets, relation-specific investments and other forms of synergy, we assume that in the case of integration (I) productivity is higher than in the no-integration case, that is, $a_I > a_U + a_D + a_U a_D$. Consistent with focusing on revenue side, we assume that integration does not affect cost of the upstream firm. Integration of firms is costly because of regulation obstacles, reorganization disruptions, etc. Hence, we assume that the flow cost of integration is χC_i . This setup brings us directly to the GMH argument where costs and benefits of integration are analyzed.

The no-looting after-tax profits are

$$U: \pi_U = (1 - \tau)(S_U - C_U) = (1 - \tau)a_U C_U,$$

$$D: \pi_D = (1 - \tau)(S_D - C_D) = (1 - \tau)(S_D - S_U) = (1 - \tau)a_D(1 + a_U)C_U,$$

$$I: \pi_I = (1 - \tau)(S_D - C_U) = (1 - \tau)a_I C_U.$$

An owner will choose to keep firms separately (Scenario 1) or integrate them into a conglomerate (Scenario 2) depending on which scenario yields a larger profit. The relevant comparison is again the looting oligarch versus the transparent owner. The change in the after-tax profit of the transparent owner who integrates firms is $\Delta B^L = \pi_I - \pi_D - \pi_U - \chi C_i$.¹¹ If $\Delta B^L > 0$, the transparent owner integrates firms, captures the gains in productivity and generates higher tax revenues.

For the oligarch, the change in benefit is

$$\Delta B^O = B_I - B_D - B_U - \chi C_i, \quad (6)$$

where B_I , B_D , and B_U are the oligarch's benefits from running integrated, downstream and upstream firms, respectively. Using Proposition 5, we prove the following result.

Proposition 4.

- 1) The oligarch has greater incentives to integrate firms vertically if assets are complementary, investments are relation specific or there are other synergies from the merger. Specifically it always holds that $\Delta B^O \geq \Delta B^L$.

¹¹ We assume that the cost of investment is not tax deductible.

- 2) Under certain conditions, the integrating oligarch generates higher tax revenues than the transparent owner who does not merge firms.

Proof: see Appendix.

There are several reasons why the oligarch wants to integrate firms. First, he economizes on the fixed cost of running an off-shore company. Second, by raising productivity from a_D and a_U to a_I the oligarch can more easily tunnel a fixed percentage of sales and transfer it to his off-shore company.¹² Recall that the oligarch's ROC is increasing in the firm size and productivity. Because synergies from the merger raise the overall productivity of the formed conglomerate, the oligarch's benefit increases more than that of the transparent owner and, therefore, under certain constellations of productivity parameters and costs of merger, the oligarch rationally chooses to invest when the transparent owner does not. Given the fact that the oligarchs are likely to face smaller integration costs because of their political connections, they effectively have even greater incentives to integrate firms. Proposition 4 rationalizes stylized fact #2.

The second part of the proposition addresses the question of whether the government should stimulate integration. The answer is clearly "yes" if the owners are transparent because mergers increase the tax base. What about the oligarchs? The answer depends on the relative strength of the productivity gains and looting motives. Like in our analysis of investment, if a productivity gain is sufficiently large and an increase in looting is small, tax revenues increase when the firms are integrated.

Propositions 3 and 4 combined suggest that oligarchs, *ceteris paribus*, will tend to generate surplus, which would otherwise go unnoticed, by integrating vertical production chains and investing into profitable projects. As long as the amount looted by the oligarchs is less than the incremental surplus for the economy, these activities are socially beneficial. The incentive for oligarchs to engage in such ventures is rooted in the existence of some "tax-free" extra profit which is looted to off-shores. The relative efficiency of oligarchs compared to transparent owners is thus directly dependent on the level of δ^* , among other things. We can label this type of efficiency as the "**first-order**" efficiency.

Hart (1995), however, argues that although some basic forms of property rights arrangements can yield better results than others, none is able to produce the first-best levels of investment and maximize trade surplus in absolute terms. We now move on to show that under certain circumstances oligarchs are not only able to be relatively more efficient, but may also demonstrate absolute efficiency in choosing investment levels and maximizing production surplus.

Proposition 5.

Under certain circumstances oligarchs can achieve maximum socially desirable levels of investment, unattainable by other ownership arrangements.

Proof: see Appendix.

¹² Thus, the oligarch has incentives to integrate firms even in the absence of synergies.

Proposition 5 contains an even stronger result than Propositions 3 and 4 combined — it suggests that in some cases the oligarch's ownership can be superior to other forms of integration. The efficiency described in Proposition 5 has a different nature from that mentioned earlier, since it derives not from the level of δ^* , but from the ability of the oligarch to vary δ^* with the level of investment and sales (the **"second-order" efficiency**). Hence Proposition 5 suggests viability of business conglomerates controlled by strong outsiders in the long run.

Our results are consistent with reality. Oligarchs indeed tend to own larger firms. Although in practice oligarchs tend to own profitable firms, they do own unprofitable firms as well. If the firm has high productivity (or markup), it is easier to hide transfer of resources and report "standard" profits. In economies with low taxes and high penalty for looting, oligarchs rationally choose to stay within legal limits. Oligarchs tend to loot aggressively firms in which they have a small stake. The model also explains why profits of a single firm owned by an oligarch can fail to reveal information about productivity of the oligarch's chain of firms as a whole and measured productivity can be low.

Our model accounts for all stylized facts we have listed above. The model shows that oligarchs can be parasites in the sense that they do not generate additional surplus and simply redistribute profits. Yet, the model also demonstrates that if there are synergies from integrating production chains or productivity enhancing investments, oligarchs are likely to generate surplus and benefit the society. As we argue below, reintegration of production chains could have significantly contributed to economic recovery of transition economies including Ukraine and, consequently, oligarchs could have played an important role in this recovery. Finally, the model can explain why conglomerates led by oligarchs may be a viable form of organization even as the economy develops and more progressive institutions enter the scene.

2.3. Discussion and context

Using our framework, we can construct a consistent story of the development of industries in the former Soviet Union (FSU) in the 1990s. In the Soviet era, the state was the sole owner of residual control rights in all medium and large-sized enterprises. The system was designed to fulfill the plan and maximize output of certain top-priority goods and services (in order of importance — military sector products, industrial construction, basic necessities). The degree of vertical integration was close to its technological maximum and the whole system was driven by a state plan. Although the plan was supposed to be a product of objective budgeting and to some extent inter-enterprise bargaining (either direct or through government coordinators), upstream firms, which produced products from a top-priority list, and their immediate contractors had significant bargaining power over the downstream firms. This resulted in considerable overinvestment in physical capital¹³ in heavy industries and underinvestment in most consumer-oriented industries.

¹³ The analyses of inefficiencies and anomalies pertaining to planned economies may be found in Kornai (1992) or in more recent work by Gaidar (1997).

Upon the break-up of the USSR, the state lost much of its power and *de facto* residual rights of control were appropriated by the management of respective firms. This corresponds to the non-integration ownership structure of the previous section. Underinvestment did indeed occur and total value of specific relationships within the economy, as well as its output, have declined dramatically (see Fig. 1). It is worth emphasizing that underinvestment was equally acute for heavy industries, as well as for the light industries — in case of the latter it was associated with more explicit underinvestment in new technology and new capacities, in case of the former it took the form of insufficient investment into restructuring of installed capacities and refurbishment of technological process.

Disorganization of production is the leading explanation of the U-shaped dynamics in output. Blanchard and Kremer (1997) suggest that private potential uses of resources outweigh conventional state uses and divert inputs from the public sector of the economy. This generates downturn in output. In the course of time, private uses improve and total output rise. Roland and Verdier (1999) develop a search model where firms of two types, "low productivity" and "high productivity", engage in vertical productive relationships. Fall in output is explained as diversion of resources from production to search for better production matches. Like the Blanchard–Kremer model, this model also predicts the U-shape trajectory in output. Although both models are built on solid micro-foundations, neither can explain who restores production chains, why it takes more time to recover for some countries than the other, why firms did not reintegrate quickly after liberalization. One of the contributions of this paper is in providing an account of who improves private uses and who makes efficient matches of firms. We argue that oligarchs in Ukraine and other FSU countries could have been that anonymous revitalizing force in disorganization models and, thus, oligarchs could have contributed to economic recovery in the FSU countries by reintegrating production chains.

On empirical side, tests of disorganization theories (*e.g.*, Konings and Walsh 1999, Recanatini and Ryterman 2000, Johnson, McMillan, and Woodruff 2002, Marin and Schnitzer 2002) largely ignore the role of *property rights* arrangements in explaining disorganization and output path in transition. We conduct an empirical test of the impact oligarch ownership has on the recovery of output and, to some extent, fill this niche.

In order to make predictions of our model testable, we need to specify who the oligarchs are and how these oligarchs improve performance. We first define who can be labeled an "oligarch" in the context of the Ukrainian economy. Clearly, it should be someone who employs enough of financial resources to appropriate controlling stakes and control the management in a number of large vertically related enterprises, has enough political weight and lobbying ability to secure attained residual control rights, and possesses enough bargaining power to implement redistribution of cash flows within the group and enforce internal and external contracts. Specifically, an entity is nicknamed an "oligarch" if it meets the following criteria:

- the entity controls at least three enterprises in the industry that may potentially engage in vertical integration;

- the entity itself is not a manufacturing enterprise within the same industry;
- the entity has at least one representative in the parliament that is legally or publicly associated with this entity or the group controlled by it.¹⁴

Oligarchs in the post-Soviet countries have very much in common with Korean *chaebol*, Japanese *keiretsu*, or other 'family'-like business groups across the world (La Porta, Lopez-De-Silanes, and Shleifer, 1999).

The next step is to analyze particular mechanisms by which an "oligarch" can improve enterprise performance and induce larger investment. We have uncovered four such basic mechanisms:

- *pure coordination* — improved group-level planning and management X-efficiency, related to observability and verifiability of investments;
- *contract enforcement* — imposition of a binding discipline on group enterprises and effective enforcement of delivery by outside contractors brings in more certainty into the trade relationship and makes outside options less binding;
- *internal capital markets* — markets established within a group to ensure that marginal productivity of investments is equalized throughout the group and first-best levels of investment are attained;
- *access to external finance* — the ability of an "oligarch" to provide a cheaper and better access to external lending sources for all members of the group.

Our approach is explicitly concentrated on the first two mechanisms but it nests all the four. Indeed, organization of internal capital markets is a prerequisite for a successful "oligarch" integration (recall that the oligarch must be able to move resources within the group to maximize total surplus). Improved access to external finance is largely a result of enhanced financial management, removal of severe information asymmetries, and increased security of property rights — in a typical business group all these developments can be reasonably attributed to improved coordination and contract enforcement.¹⁵ Since all these four channels are highly interconnected, we do not separate them and instead focus on the aggregate effect.

In brief, the GHM theory indicates that certain property rights arrangements promote efficiency in investment and production, while others do not. In particular, our propositions suggest that oligarchs creating closed groups of vertically integrated enterprises can be associated with increased volumes of investment and improved enterprise performance.

¹⁴ This criterion is supposed to filter those groups that have no sufficient political power and thus are extremely susceptible to political or legal action by competitors, which would endanger contract enforcement or even ownership claims.

¹⁵ There is a large literature studying the internal markets for members of business groups, *e.g.*, Samphantharak (2003) and literature cited therein. The relevance of liquidity constraints in the context of transition economies has been extensively studied, *e.g.*, Marin and Schnitzer (2002).

3. AN EMPIRICAL TEST OF THE OLIGARCHY THEORY

While our model yields a number of potentially falsifiable predictions, unfortunately, we are not able to test many of them because of the enormous size of industrial groups (up to 800 legal entities), unobservable nature of looting, lack of consolidated reporting, and presence of numerous trade houses and off-shore vehicles within the conglomerates. As a result, we focus on the following testable prediction: the presence of an oligarch improves the performance (productivity) of *each* enterprise entering his group. To test this hypothesis, we estimate a production function and, controlling for selection, examine whether productivity of firms owned by oligarchs is, *ceteris paribus*, higher than that of firms not owned by oligarchs.

3.1. Data

We rely on two original sources of information: the State Stock Market and Securities Commission (SSMSC) and the State Statistics Committee (SSC). Both agencies are collecting enterprise-level financial, ownership and operating data on an annual basis and maintain comprehensive databases: the former carries out this function for all entities that are either incorporated as open joint stock companies (OJSCs), or issue publicly traded securities; the latter collects data for all legally registered businesses in Ukraine. The two datasets are merged by unique firm codes.

The SSC collects a relatively small set of economic indicators such as number of employees, sales, value added, and capital assets. The key feature of this data set is that it starts at 1993 (just before privatization and after liberalization) with reasonably large cross section of firms. The data collected by the SSMSC are by far more informative but complete cross-sections of OJSCs are available only for recent years. SSMSC requires firms to disclose externally audited balance sheets and income statements, records on capital investments, and management board composition. The key variable from this data set is ownership structure: shares and owners are identified (name, EDRPOU code, country of origin, share). We complement this information with detailed ownership records for 2002 in the database maintained by the Association of Registers of Ukraine (ARU) and the State Tax Administration of Ukraine (STAU). We utilize these data sets to track ownership relationships between enterprises and business groups, *i.e.*, we separate entities controlled by 'oligarchs' from common publicly or privately held ventures and state-owned enterprises.

Since ownership information is generally available only for firms present in SSMSC data set, our working sample is not representative for small firms. Naturally, SSMSC firms tend to be larger. Although *a priori* effects of property rights allocation and security on a firm's performance and investment pattern are expected to be significant regardless of the firm's size, we limit the scope of our analysis to fairly large enterprises for a number of reasons. First, small enterprises are less likely to be involved in business conglomerates, as their expected cash generating ability (which is blatantly related to firm size) is relatively small in comparison to the transaction costs of integration and coordination. Second, small enterprises in Ukraine are subject to far less strict disclosure requirements than their medium and large-size counterparts. Third, reliability of financial information provided by the small companies is presumably much poorer because of less stringent reporting re-

quirements, lax accounting procedures, and a much weaker public control. Hence, we consider firms with at least 500,000 UAH (approximately USD 100,000) in assets.¹⁶

Our working data set consists of firms present in both i) 1993 in SSC data base and ii) 2002 in SSMSC dataset. The size of this sample is 1,917 firms while the size of SSC data set in 1993 is approximate 7,000 and the size of SSMSC data set in 2002 is approximately 8,000 firms. In the course of privatization, large firms were required to be incorporated before they are sold out while relatively small enterprises did not have to be incorporated.¹⁷ Thus, we are more likely to find larger firms in this sample. Attrition effects are likely to be small in determining the composition of the sample because large firms are very unlikely to go bankrupt in Ukraine predominantly for political reasons and weak bankruptcy laws.¹⁸

Oligarchs are the key ingredient in our analysis. Our working definition of oligarchs (see previous sections) identifies 13 oligarchic groups with *System Capital Management* led by Rinat Akhmetov being the largest group in Ukraine (Table 1). In total, they control 276 firms (14% of sample). We draw on various sources, most importantly SSMSC/ARU/STAU data and business press,¹⁹ to determine if a given enterprise is owned by an oligarch. This task is particularly challenging since oligarchs very rarely directly own OJSCs and it is typically a chain of holdings, intermediate firms, and off-shore companies.²⁰

A simplified corporate structure of a typical Ukrainian oligarchic group "Pryvat" is presented in Fig. 2. More complete structures for this and other groups can be found in Investgazeta (2003, 2004).²¹ Note the presence of the off-shore companies, which is an essential feature for all oligarchs. The "Pryvat" group, like other oligarchic groups, has vertically integrated chains in production of metals and chemicals. Parallel examples from Russia are Lukoil of Alekperov²² and, until recently, Yukos of Khodorkovsky.

Main descriptive statistics are reported in Table 2. On average, the firms owned by oligarchs have larger profits than firms in the control group. Yet, the large standard deviation indicates that loss-making firms are not uncommon in oligarchic groups. Not surprisingly, oligarchs tend to have

¹⁶ We omit the criterion for the number of employees, commonly used for such filtering, in order to retain trade and financial intermediaries in the sample.

¹⁷ Even firms 100% owned by the state are incorporated in anticipation of future privatization.

¹⁸ Sample selection is negligible for most specifications we consider as the coefficient on the Mills ratio is not statistically different from zero.

¹⁹ This source is particularly helpful in identifying off-shore companies affiliated with oligarchic groups. Two particularly useful reviews of oligarchic groups were published in Investgazeta (2003) and Bondarenko (2003).

²⁰ With respect to Berezovsky, one of the most prominent Russian oligarchs, Hoffman (2002, p. 401) observes, "... his (Berezovsky's) holdings were a mysterious empire shielded by layers of shell companies and off-shore havens."

²¹ Analogous structures for Russian oligarchs can be found in Pappe (2000).

²² See, for example, Hoffman (2002) and "In the land of Oligarchs" by Peter Maass in New Your Times Magazine (Aug 1, 2004).

stakes in larger firms. In our sample an average oligarch-owned firm has triple the amount of total assets on its balance sheet compared to its counterpart from the control group. The ratio for the number of employed is of the same rank: 1520 employees for an average firm belonging to some business conglomerate versus only 514 for a typical enterprise in the control group.

Being strongly biased towards heavy-manufacturing companies, oligarchs seem to control the lion's share of the real capital stock in terms of book value: 35.2% in our sample. In 1993, the enterprises that we deemed to be oligarch-owned in 2002 controlled 37.8% of the capital assets in the sample. In both periods, an average firm from the oligarch group has far "richer" capital endowment: net book value of fixed assets is approximately 3 times larger for such an enterprise than for a typical control group representative.²³ The gap does not seem so large when put into per employee terms: amount of capital per employee is only 9.4% larger for an oligarch-owned firm than for non-oligarch-owned firms. This difference does not seem large enough to fully explain the 23% difference in value added per employee between these two groups of firms.

In terms of industry concentrations, oligarchs have the largest representations in metals and chemical industry. This is also hardly surprising because these industries are export oriented and as such are the most secure source of hard currency cash flows. Since most enterprises in these industries are in the Eastern Ukraine, oligarchs have the largest share of firms owned in the Eastern Ukraine.²⁴

We believe that all the basic observations we made above while examining our sample can be plausibly applied to the Ukrainian economy at large without a loss of significance (at least to the manufacturing sector). Although the constructed sample contains only open joint stock companies, it captures most of the national 'blue chips'. The sampled firms account for approximately 12.5% of Ukrainian GDP in 2002 and for about 18.9% of value added in the industry and services.²⁵ This is a large share indeed, though not unexpected — open public companies produce slightly more than 30% of Ukrainian GDP and our sample comprises the largest quarter of them. In brief, the sample is interesting from both academic and policy standpoints.

3.2. Econometric methods and specification

If ownership were assigned at random, difference in sample means of treatment (owned by oligarchs) and control (not owned by oligarchs) groups would be a consistent estimate of the average treatment effect of being owned by an oligarch. Unfortunately, Table 2 clearly reveals that the as-

²³ Of course, one should take these estimates of capital stock quite cautiously. Yet, given no material differences in accounting practices of oligarchs and the control group, the number indicated above should give a meaningful estimate of the gap between the firms in each group.

²⁴ Note that other industries and sectors such as transport and agro-business are not in our sample. We have to drop observations in these sectors because we did not have data for these firms in 1993. However, oligarchs do own firms in these sectors. See Fig. 2 for an example.

²⁵ Total value added for the sample amounted to 28.3 bln UAH in 2002, GDP was 226 bln UAH in the same year, value added in industry and services was 149 bln UAH (source: State Statistics Committee of Ukraine).

signment is not random and methods more sophisticated than the difference in sample means should be used to estimate the treatment effect.

We employ two methods to consistently estimate average treatment effect (ATE) of oligarchs on firm performance: instrumental variables (IV) and Maddala's (1983) treatment effects (TE) model. These methods are based on similar assumptions. Wooldridge (2002) and Vella and Verbeek (1999) note that while TE is more efficient than IV, IV is more robust to various misspecifications. Both methods fix an apparent flaw in observational studies: non-random assignment of treatment. These methods, nevertheless, require correctly excluded predetermined or exogenous variables explaining oligarch's choices; otherwise, one cannot credibly isolate treatment effect from non-random selection.

Fortunately, we can trace firms from pre-privatization days (*i.e.*, before 1994) to present time. In 1993, essentially all large firms were state owned. Thus, we have some uniformity in the pre-treatment. Importantly, prices were liberalized before 1993 so that firm performance in 1993 is a better indicator of future profitability than performance in earlier periods when prices were largely regulated. Hence firm characteristics in 1993 were very important for oligarchs in 1995–1999 when most firms were privatized. In 2002, large firms have been by and large incorporated and thus they show up in our sample. Some firms have been treated (*i.e.*, oligarchs decided to own these firms) and some not.

As for the model governing oligarch's choices, our theoretical results indicate that the firm size and productivity are the relevant variables. We measure productivity as output to capital ratio, which is a proxy for return on capital, and output to labor ratio, which is a proxy for labor productivity. Firm size measured by sales is particularly important as it differentiates transparent owners from oligarchs. In addition, we include firm's capital assets to capture asset stripping motive with larger capital stock being *ceteris paribus* more attractive for oligarchs. Capital assets and employment may also serve as proxies for the firm size. Profitability in 1993 appears to be a poor predictor of firm's cash generating ability because in 1993 most firms had a heavy burden of social commitments, *e.g.*, financing kindergartens and hospitals for their employees. As a result, our selection (TE) or first stage (IV) equation is

$$OLIGARCH_i = \Phi\left(\alpha_1 \ln Sales_i^{(93)} + \alpha_2 \ln L_i^{(93)} + \alpha_3 \ln K_i^{(93)} + X_i^{(93)}\gamma + \varepsilon_i\right), \quad (7)$$

where i indexes firms, $OLIGARCH$ is a dummy variable equal to one if the firm is owned by an oligarch and zero otherwise, $Sales_i^{(93)}$ are sales in 1993, $L_i^{(93)}$ is the number of employees in 1993, $K_i^{(93)}$ is the beginning of the year value of capital in 1993, X is a set of industry and regional dummies for 1993, and Φ is the c.d.f. of the standard normal distribution. Note that because we use variables in logs, specification (7) is the reduced form of a specification that, in addition to levels of the variables, includes output/capital, output/labor, and capital/labor ratios.

To measure the effect of the oligarch on firm productivity, we estimate the Cobb–Douglas production function in growth rates of the respective variables between 1993 and 2002. The precise speci-

fication is as follows:

$$\begin{aligned} \log VA_i^{(02)} - \log VA_i^{(93)} &= \\ &= \alpha_K [\log K_i^{(02)} - \log K_i^{(93)}] + \alpha_L [\log L_i^{(02)} - \log L_i^{(93)}] + \beta \cdot OLIGARCH_i + X_i\gamma + u_i, \end{aligned} \quad (8)$$

where VA_i is the value added, K_i is the capital (fixed assets beginning of the period), L_i is the average number of employees, X_i is the set of regional and industry dummies. Importantly, because we estimate production function in log differences, we eliminate firm specific productivity and therefore avoid endogeneity of inputs arising from transmission bias identified by Marschak and Andrews (1944). Furthermore, note that using growth rates over long horizons attenuates possible adverse effects of measurement errors in the right hand side variables, especially capital (see Griliches and Hausman 1986). The estimate of β measures the effect of the oligarch's ownership on the firm's productivity.

The treatment effects model estimates (7) and (8) simultaneously. A useful byproduct of estimating TE model is the correlation coefficient for u_i and ε_i , the sign of which can inform us about direction of bias in the OLS estimates. In contrast, IV uses estimated probability from (7) to instrument *OLIGARCH* in (8).²⁶

3.3. Results

The estimates of the first stage regression (7) are presented in Table 3. Consistent with our theoretical model, the volume of sales and capital stock are important determinants of the oligarch's ownership. Interestingly, employment is irrelevant provided capital and sales are included. This suggests that labor productivity, which in contrast to sales is not directly observable, was not particularly important for oligarch's decision to own a firm. This appears to be consistent with anecdotal evidence. We also do not find any specific regional preference in oligarchs' choices. However, owning firms in the metal industry appears to be oligarch's desideratum. Machine building, light/food and chemical industries are also relatively more attractive to oligarchs than firms in the energy and services sectors. Overall, the model is statistically significant at all conventional significance levels and it has a reasonable fit.

Table 4 presents the estimates for the production function given by equation (8). We include only one regional dummy *Kyiv* because other regional dummies have economically small and statistically insignificant coefficients. When the model is estimated by OLS (column 2), the coefficient on *OLIGARCH* is positive but not statistically significant. The coefficients on labor and capital are statistically significant with the sizes typically found for production functions estimated on long differences of output and inputs (*e.g.*, Tybout and Westbrook, 1996). The magnitude of the coefficient on the labor growth rate reflects the fact that labor proxies all variable inputs and unobserved effort and utilization rates.

²⁶ Details on the procedure can be found in Wooldridge (2002, Chapter 18). Importantly, the first stage may be misspecified and one does not have to correct standard errors in (8) for using an estimated probability as an instrument.

OLS does not correct for the endogeneity of *OLIGARCH*; thus, finding a weak difference in productivity does not refute our argument. Once endogeneity is taken into account, oligarchs do appear to have a higher productivity than other owners. Specifically, IV and TE estimates indicate that, *ceteris paribus*, oligarchs have 50–70% higher value added growth rate than non-oligarchs over the period that we study. Although the size of the coefficient may appear to be somewhat large, it is plausible in the Ukrainian context. Recall that economic collapse in the early 1990s (by 1997, GDP fell by 60%) led to very low capacity utilization rates. There is extensive anecdotal evidence that inactive and largely idle plants were turned into three-shift plants with the change of owners.²⁷ Hence, a quick 50% expansion of output is more than likely.

Note that the correlation $\rho(u_i, \varepsilon_i)$ is statistically significantly different from zero (column 5). Likewise, the Hausman test (column 3) rejects the equality of OLS and IV estimates. Thus, estimating (8) by OLS does not yield a consistent estimate of β . Also a negative correlation between u_i and ε_i suggests that oligarchs pick underperforming firms and then improve their productivity. This is generally in agreement with our theoretical model. Note that large firms created in the Soviet time could have been relatively unproductive in the market economy. According to our model, oligarchs should want to have large and not necessarily productive firms. Once they acquire large firms they have incentives to enhance firm's productivity.

Of course, these results depend on whether the probability of being owned by an oligarch is a sufficiently strong instrument for actual ownership by an oligarch. To verify that the instrument is not weak, we consider the following diagnostic statistics. First stage F-statistic is well above 20, the critical value suggested by Stock, Wright and Yogo (2002, Table 1, p. 522). Hence, it is unlikely that the instrument is weak. Alternatively, one can consider inference methods that are fully robust to weak instruments, *e.g.* Anderson–Rubin (AR) statistic. We find that the AR statistic for the null hypothesis $\beta = 0$ exceeds the 5% critical value computed as in Moreira (2003). Therefore, our conclusions are robust on this front as well.

The results survive in a number of robustness checks. Modifications in specifications and samples lead to qualitatively the same conclusions. Therefore, oligarchs are indeed likely to improve productivity of firms.

4. CONCLUDING REMARKS

Our paper provides a theoretical model and an empirical test of the economic behavior of "oligarchs", the strong financial and industrial groups observed in many countries in the Central and South-East Asia, Latin America, and Central and Eastern Europe.

²⁷ See for example, "Alchevsk Steel Mill: A Year for Five" in Zerkalo Nedeli (#42, 1999) and "The Conflict of Special Interest" in Zerkalo Nedeli (#39, 2003).

Our theoretical model explains important stylized facts about the oligarch's behavior. The model predicts that the oligarch is more likely to invest in productivity enhancing projects and vertically integrate firms to capture the gains from possible synergies than other owners. We argue that economic recovery in transition countries of the FSU is linked to formation of strong business groups restoring and reinvigorating production chains.

We test implications of the model using a unique data set constructed from a number of firm level data bases. Importantly, unlike other studies analyzing business groups, our empirical tests control for endogeneity of firm ownership. Our econometric results suggest that oligarchs are "good" along at least some dimensions. In particular, oligarchs do appear to stimulate productivity, that is, firms owned by oligarchs tend to have higher productivity growth than firms not owned by oligarchs. This result is compatible with Olson's "stationary bandit", *i.e.*, even robber barons can be socially beneficial.

Policy implications of our results are not straightforward. Oligarchs have other consequences than just promoting productive efficiency. In particular, oligarch's activities inevitably lead to a concentration of the industry. Oligarchs can gain monopolistic power and exploit it to their own benefit, causing thereby losses to the society. Normative issues such as distribution of surplus should be also considered.

In general, a detailed cost-benefit analysis is required to make a final judgment concerning desirability of wide scale "oligarch" integration for the whole economy, and this research can be a starting point for this analysis. Intuitively, one may expect that costs are likely to outweigh benefits in the long run — given the examples of "oligarch" societies like Indonesia. Indeed, Acemoglu (2003) presents a model where oligarchic societies can dominate democracies in the short run but democracies dominate oligarchies in the long run. Nonetheless, existence of integrating groups is typical for all the developed economies as well and their ultimate utility seems to be a matter of effectiveness of public control.

APPENDICES

A1. Equation

Proof of Proposition 1.

To keep $f(\delta^* - a_i/(1+a_i)) < \infty$, the optimal looting trivially satisfies $\delta^* < a_i/(1+a_i)$.

After taking derivative from (2) observe that

$$\frac{\partial \delta^*}{\partial a_i} = \frac{1}{(1+a_i)^2} + \frac{1}{f''(\delta^* - a_i/(1+a_i))} \tau C_i > 0$$

by assumptions imposed on the penalty function.

After taking derivative from (2) observe that

$$\frac{\partial \delta^*}{\partial S_i} = \frac{\tau}{f''(\delta^* - a_i/(1+a_i))} > 0$$

by assumptions imposed on the penalty function.

After taking derivative from (4) observe that the larger the fee/penalty for looting firms, the less attractive looting is, *i.e.*

$$\partial \Delta B_i^* / \partial \phi = -1 < 0.$$

The proof for f follows by analogy.

After taking derivative from (4) observe that by the envelope theorem

$$\partial \Delta B_i^* / \partial \tau = \delta^* S_i > 0.$$

QED.

Proof of Proposition 2.

Suppose that firm equity capital K_i is proportional to sales S_i : $\kappa K_i = S_i$. Then return on capital (ROC) is

$$\begin{aligned} ROC &= \frac{\delta^* S_i \tau + (1-\tau) \frac{a_i}{1+a_i} S_i - f(\delta^* - a_i/(1+a_i)) - \phi}{K_i} = \\ &= \left[\kappa \delta^* \tau - \kappa \frac{f(\delta^* - a_i/(1+a_i)) + \phi}{S_i} \right] + \kappa (1-\tau) \frac{a_i}{1+a_i}. \end{aligned} \quad (A.9)$$

The second term in (A.9) is the ROC received by a transparent owner. As long as the first term is positive the oligarch is looting firms. Note that the derivative of the first term with respect to S_i is

$$\frac{1}{S_i^2} \left[f(\delta^* - a_i/(1+a_i)) + \phi \right] > 0.$$

Hence, the oligarch's ROC is increasing in the firm size. In contrast, the firm size is irrelevant for the ROC of a transparent owner.

Both the oligarch and the transparent owner have ROC increasing in a_i through the second term in (A.9). Using results from Proposition 1, we find that the derivative of the first term in (A.9) with respect to a_i is

$$\kappa\tau \frac{\partial \delta^*}{\partial a_i} + \tau + \frac{f(\delta^* - a_i/(1+a_i))}{(1+a_i)^2 C_i} > 0.$$

Hence, the first term in (A.9) is increasing in productivity a_i . It follows that the oligarch's return is weakly larger than the ROC of the transparent owner.

QED.

Proof of Proposition 3.

Suppose in the no-investment case, the oligarch chooses to loot the firm. His benefit function under no-investment case is

$$B_{1i}^* = \delta_1^* (1+a_{1i}) C_i + (1-\tau) \left((1-\delta_1^*) (1+a_{1i}) - 1 \right) C_i - f \left(\delta_1^* - \frac{a_{1i}}{1+a_{1i}} \right) - 1_{\delta > 0} \phi, \quad (\text{A.10})$$

where $\delta_1^* = \delta(a_{1i})$. With investment the benefit is

$$B_{2i}^* = \delta_2^* (1+a_{2i}) C_i + (1-\tau) \left((1-\delta_2^*) (1+a_{2i}) - 1 \right) C_i - f \left(\delta_2^* - \frac{a_{2i}}{1+a_{2i}} \right) - 1_{\delta > 0} \phi - \chi C_i, \quad (\text{A.11})$$

where $\delta_2^* = \delta(a_{2i})$. After subtracting optimized (A.10) from (A.11) and using the definition for ΔB_i in (4), we have:

$$\begin{aligned} B_{2i}^* - B_{1i}^* &= \left[(1-\tau)(a_{2i} - a_{1i}) - \chi \right] C_i + \\ &\quad + \tau C_i \left(\delta_2^* (1+a_{2i}) - \delta_1^* (1+a_{1i}) \right) + f \left(\delta_1^* - \frac{a_{1i}}{1+a_{1i}} \right) - f \left(\delta_2^* - \frac{a_{2i}}{1+a_{2i}} \right) = \\ &= \left[(1-\tau)(a_{2i} - a_{1i}) - \chi \right] C_i + \left[\Delta B_{2i} - \Delta B_{1i} \right]. \end{aligned} \quad (\text{A.12})$$

The first term in (A.12) is the change in after-tax profit of the transparent owner who makes the investment if $(1-\tau)(a_{2i} - a_{1i}) - \chi > 0$. The second term is specific to the looting oligarchs. Note that

by the envelope theorem (4) that

$$\partial \Delta B^* / \partial a_i = \tau \delta^* C_i + (1 + a_i)^{-2} f'(\delta^* - a_i / (1 + a_i)) > 0.$$

Hence, the second term is always positive. If the transparent owner makes the investment, the oligarch also makes the investment. For some constellation of a_{1i}, a_{2i}, χ , the oligarch makes the investment when the transparent owner does not.

QED.

Proof of Proposition 4.

1) Note that in the case of the transparent owner the change in the profit is equal to

$$\begin{aligned} \Delta B^L &= \pi_I - \pi_D - \pi_U - \chi C_i = \\ &= (1 - \tau) a_I C_U - (1 - \tau) a_D (1 + a_U) C_U - (1 - \tau) a_U C_U - \chi C_i = \\ &= C_i [(1 - \tau)(a_I - a_U - a_D - a_D a_U) - \chi]. \end{aligned}$$

In the case of the oligarch, the change in the benefit is equal to

$$\begin{aligned} \Delta B^O &= B_I - B_D - B_U - \chi C_i = \\ &= C_i [(1 - \tau)(a_I - a_U - a_D - a_D a_U) - \chi] + \\ &+ \left[\phi + f(\delta_D^* - a_D / (1 + a_D)) + f(\delta_U^* - a_U / (1 + a_U)) - f(\delta_I^* - a_I / (1 + a_I)) \right] + \\ &+ \tau C_i (\delta_I^* (1 + a_I) - \delta_U^* (1 + a_U) - \delta_D^* (1 + a_D) (1 + a_U)). \end{aligned} \quad (\text{A.13})$$

Hence,

$$\begin{aligned} \Delta B^O - \Delta B^L &= \left[\phi + f(\delta_D^* - a_D / (1 + a_D)) + f(\delta_U^* - a_U / (1 + a_U)) - f(\delta_I^* - a_I / (1 + a_I)) \right] + \\ &+ \tau C_i (\delta_I^* (1 + a_I) - \delta_U^* (1 + a_U) - \delta_D^* (1 + a_D) (1 + a_U)). \end{aligned}$$

We first prove that this expression is positive for the case when $a_{I'} = a_U + a_D + a_D a_U$. Then by (2), we have

$$\delta_{I'}^* - \frac{a_{I'}}{1 + a_{I'}} = f'^{-1}(\tau S_{I'}) = f'^{-1}(\tau S_D) = \delta_D^* - \frac{a_D}{1 + a_D}.$$

Thus the first expression is necessarily positive. To prove that the second term is positive, note that

$$\delta_{I'}^* = \delta_D^* + \frac{a_{I'}}{1 + a_{I'}} - \frac{a_D}{1 + a_D}$$

and

$$\delta_U^* < a_U / (1 + a_U)$$

and, thus,

$$\begin{aligned}
 & \delta_{I'}^* (1 + a_{I'}) - \delta_U^* (1 + a_U) - \delta_D^* (1 + a_D) (1 + a_U) = \\
 & = \left(\delta_D^* + \frac{a_{I'}}{1 + a_{I'}} - \frac{a_D}{1 + a_D} \right) (1 + a_D) (1 + a_U) - \delta_U^* (1 + a_U) - \delta_D^* (1 + a_D) (1 + a_U) > \\
 & > \left(\frac{a_{I'}}{1 + a_{I'}} - \frac{a_D}{1 + a_D} \right) (1 + a_D) (1 + a_U) - \frac{a_U}{1 + a_U} (1 + a_U) = \\
 & = \frac{1}{(1 + a_D)(1 + a_U) + 1} > 0.
 \end{aligned}$$

We conclude that

$$\Delta B^O - \Delta B^L > 0 \text{ for } a_{I'} = a_U + a_D + a_D a_U.$$

By the envelop theorem

$$\partial \{ \Delta B^O - \Delta B^L \} / \partial a_I = \frac{\partial}{\partial a_I} \left\{ \tau \delta_I^* (1 + a_I) C_i - f \left(\delta_I^* - a_I / (1 + a_I) \right) \right\} > 0.$$

Hence, $a_I > a_{I'}$ implies that

$$\Delta B^O - \Delta B^L > 0.$$

2) The change in the tax revenues is

$$\begin{aligned}
 \Delta T_i &= \tau C_i \left[(1 - \delta_I^*) (1 + a_I) - 1 \right] - \tau C_i \left[(1 - \delta_U^*) (1 + a_U) - 1 \right] - \tau C_i \left[(1 - \delta_D^*) (1 + a_D) - 1 \right] (1 + a_U) = \\
 &= \tau C_i \left[(a_I - a_D - a_U - a_U a_D) + \delta_D^* (1 + a_D) (1 + a_U) + \delta_U^* (1 + a_U) - \delta_I^* (1 + a_I) \right] = \\
 &= \tau C_i \left[(a_I - a_D - a_U - a_U a_D) (1 - \delta_I^*) + (\delta_D^* - \delta_I^*) (1 + a_D) (1 + a_U) + \delta_U^* (1 + a_U) \right] = \\
 &= \tau C_i \left[(a_I - a_D - a_U - a_U a_D) (1 - \delta_I^*) + \delta_U^* (1 + a_U) \right] + \tau C_i (\delta_D^* - \delta_I^*) (1 + a_D) (1 + a_U).
 \end{aligned}$$

The first term is positive because

$$(1 - \delta_I^*) (1 + a_I) - 1 > 0,$$

i.e. profit margin must be always positive otherwise the firm is declared bankrupt (see Proposition 1). The second term is always negative because

$$\partial \delta_i^* / \partial a_i > 0 \text{ and } a_I > a_D.$$

If the productivity gain is sufficiently large and increase in looting is small, tax revenues increase when the firms are integrated.

QED.

Proof of Proposition 5.

Following Hart's (1995), we assume that downstream firm can make revenue increasing investment i and upstream firm can make cost enhancing investment e . We use subscripts I , D and U to denote GHM-ideal (*i.e.* when parties have access to each other's human and physical capital), downstream agent and upstream agent cases. In addition to our standard set of assumptions, suppose that investments are observable by an owner but not verifiable.²⁸ In such circumstances, the owner is able to decide on maximum investment budget for each of the firms but delegates the investment picking to an agent. Further, assume that an agent's compensation is directly proportional to total profits of the firm he manages, so that he is motivated to maximize the latter when picking investment projects. Our set of assumptions should also include those of the basic GHM — namely, the sales of downstream firm $S_I(i)$, $S_D(i)$, $S_U(i)$ and cost of upstream firm $C_I(e)$, $C_D(e)$, $C_U(e)$ are well behaved:

$$S_{\bullet}(i) \in C^2, \frac{\partial S_{\bullet}(i)}{\partial i} > 0, \frac{\partial^2 S_{\bullet}(i)}{\partial i^2} < 0,$$

$$C_{\bullet}(e) \in C^2, \frac{\partial C_{\bullet}(e)}{\partial e} < 0, \frac{\partial^2 C_{\bullet}(e)}{\partial e^2} > 0,$$

and ideal integration dominates other forms of integration, *i.e.*

$$S_I(i) > \max\{S_D(i), S_U(i)\}, \frac{\partial S_I(i)}{\partial i} > \max\left\{\frac{\partial S_D(i)}{\partial i}, \frac{\partial S_U(i)}{\partial i}\right\} \quad \forall i,$$

$$C_I(e) < \min\{C_D(e), C_U(e)\}, \frac{\partial C_I(e)}{\partial e} < \max\left\{\frac{\partial C_D(e)}{\partial e}, \frac{\partial C_U(e)}{\partial e}\right\} \quad \forall e.$$

Obviously, upstream and downstream firms can make at most a profit of

$$\pi_I = \max_{i,e} \{S_I(i) - C_I(i) - i - e\}. \quad (\text{A.14})$$

The first order condition for (A.14) (2.12) with respect to i and e gives:

$$\frac{\partial S_I(i)}{\partial i} - 1 = 0, \quad (\text{A.16})$$

$$\frac{\partial C_I(e)}{\partial e} + 1 = 0. \quad (\text{A.17})$$

Hart (1995) shows that levels of investment determined by (A.16) and (A.17) are not attainable because under any form of ownership agents do not have full access to and control over human and physical capital of other members of the group, *e.g.* the upstream firm does not enjoy full control

²⁸ Just another version of the "principal-agent" dilemma.

over all assets of the downstream firm. Hence, upstream or downstream integration results in suboptimal levels of investment and by monotonicity of cost and revenue functions we, therefore, have

$$\frac{\partial S_D(i)}{\partial i} < \frac{\partial S_I(i)}{\partial i} \quad \forall i, \quad (\text{A.18})$$

$$\frac{\partial C_D(e)}{\partial e} > \frac{\partial C_I(e)}{\partial e} \quad \forall e. \quad (\text{A.19})$$

Now let us turn to the analysis of revenue increasing investment and the behavior of the downstream firm. Oligarch's revenue is $\delta_D(i)S_D(i)$. The downstream firm faces the following profit function:

$$\pi_I^D = (1 - \delta_D(i)) \cdot S_D(i) - C_D - i - f(\delta_D(i) - a_D / (1 + a_D)) - \phi.$$

The first order condition with respect to i yields:

$$-\frac{\partial S_D(i) \cdot \delta_D(i)}{\partial i} - \frac{\partial f}{\partial \delta} \cdot \frac{\partial \delta_D}{\partial i} = 1 - \frac{\partial S_D(i)}{\partial i}. \quad (\text{A.20})$$

The first term in the left hand side of (A.20) is the oligarch's marginal gain in looting revenue from investment; thus, this term is always non-negative. By assumptions of the problem and (A.18), the right hand side is always non-negative. We also know that

$$\partial f / \partial \delta > 0$$

by assumptions imposed on the penalty function f . Hence,

$$\partial \delta_D(i) / \partial i$$

must be less than zero for a well defined solution to profit maximization problem. Denote the solution to (A.16) with i^* . Provided

$$\partial \delta_D(i) / \partial i < 0$$

and

$$\delta_D(i^*) \in [0, 1],$$

the oligarch, by choosing appropriate functional form for

$$\delta_D(i),$$

can induce the downstream firm to make the first best level of investment i^* . Thus, the oligarch can achieve an outcome that is not attainable under either upstream or downstream integration. By symmetry of the problem, the same results can be shown for cost enhancing investment and the upstream firm. We conclude that the oligarch achieve superior outcomes in the GHM setup.

QED.

A2. Tables and Figures**Table 1.** Distribution of oligarch ownership by oligarchic groups and industries, 2002

Oligarchic group	Energy	Metal	Chemical	Machine building	Light and food	Service	Total
Industrial Union of Donbass (Taratuta–Mkrtchan)	0	7	0	9	0	0	16
InterProduct (Leschinskiy)	1	0	0	2	13	0	16
System Capital Management (Ahmetov)	6	16	6	49	40	1	118
Dynamo (Surkis–Medvedchuk)	3	2	1	3	3	0	12
Pryvat (Kolomoyskiy)	1	9	2	5	1	2	20
Bipe (Pinchuk)	0	4	0	2	5	0	11
InterContact (Yedin)	1	0	0	4	2	0	7
PromInvest (Poroshenko)	2	0	0	5	5	0	12
Aval (Shpyg)	1	0	0	9	9	1	20
UkrSotsBank (Khoroshkovskiy)	0	0	0	2	1	0	3
Brinkford/Orlan (Zhvania/Chervonenko)	0	0	0	2	0	0	2
UkrSibBank (Yaroslavskiy)	0	2	3	13	8	1	27
Finance&Credit (Kucherenko)	0	0	2	9	1	0	12
Total	15	40	14	114	88	5	276

Note: The table reports the number of firms that belong to an oligarchic group in a given industry in our sample. Names of the group corporate characters are in the parentheses.

Table 2. Descriptive statistics

Variable	Owned by oligarchs		Not owned by oligarchs	
	Mean, number	st.dev.	Mean, number	st.dev.
Year 2002, thousand UAH				
Number of employees	1,520	3,027	514	1,917
Capital assets	69,471	169,268	21,473	98,514
Gross profit margin	12,957	41,005	4,027	39,556
Value added	38,894	104,085	10,686	65,232
Total assets	138,997	339,880	38,252	180,287

Variable	Owned by oligarchs		Not owned by oligarchs	
	Mean, number	st.dev.	Mean, number	st.dev.
Year 1993, thousand coupons				
Number of employees	1,923	3,079	874	2,039
Capital assets	41,679	101,712	11,534	51,289
Profit	23,732	66,698	5,681	28,084
Value added	77,923	170,922	29,123	96,151
Regional distribution				
West	68		491	
East	110		431	
North-Center	54		428	
South	32		224	
Kyiv	12		67	
Industry distribution				
Energy	15		121	
Metal	40		48	
Chemical	14		52	
Machine building	114		814	
Light and food	88		550	
Service	5		56	
Number of observations	276	14.4%	1,641	85.6%

Note: Table reports median for Investment/Capital ratio.

Table 3. First stage/Selection equation. Probit estimates

Regressor	Oligarch dummy
(1)	(2)
Log(Capital ⁽⁹³⁾)	0.115** (0.048)
Log(Sales ⁽⁹³⁾)	0.162*** (0.042)
Log(Labor ⁽⁹³⁾)	-0.073 (0.057)
East	0.161 (0.101)
South	-0.034 (0.119)
North-Center	-0.086 (0.100)
Kyiv	0.097 (0.183)
Metals	0.996*** (0.193)
Chemical	0.616*** (0.227)
Machine building	0.533*** (0.158)
Light&food	0.655*** (0.178)
Services	0.369 (0.262)
Observations	1917
LR $\chi^2(12)$	135.10
Pseudo-R ²	0.088

Note: The table presents estimates of the specification (7). Dependent variable is the *OLIGARCH* dummy, which is one if an oligarch owns a firm and zero otherwise. Robust standard errors are in parentheses. Omitted industry is energy. Omitted region is west. Definitions of the variables are in the text. *, **, *** significant at 10%, 5%, and 1% respectively.

Table 4. Production function

Regressor	OLS	IV	TE 2-Step	TE
(1)	(2)	(3)	(4)	(5)
OLIGARCH	0.078 (0.068)	0.638** (0.276)	0.563** (0.284)	0.691*** (0.181)
Dlog(Capital)	0.090*** (0.035)	0.084** (0.036)	0.095*** (0.035)	0.097*** (0.036)
Dlog(Labor)	1.193*** (0.027)	1.180*** (0.036)	1.189*** (0.027)	1.189*** (0.035)
Metal	0.504*** (0.141)	0.312** (0.159)	0.339** (0.171)	0.295** (0.141)
Chemical	0.279* (0.154)	0.213 (0.177)	0.229 (0.158)	0.217 (0.174)
Machine building	0.286*** (0.095)	0.268** (0.107)	0.279*** (0.096)	0.278*** (0.106)
Light&food	0.231** (0.096)	0.215** (0.109)	0.217** (0.097)	0.213** (0.108)
Service	0.909*** (0.158)	0.915*** (0.191)	0.919*** (0.160)	0.922*** (0.191)
Kyiv	0.545*** (0.117)	0.534*** (0.126)	0.536*** (0.119)	0.533*** (0.126)
Observations	1917	1917	1917	1917
R ²	0.58	0.57		
First stage F-statistic		73.95		
AR statistic		4.83		
Hausman test: p-value		0.02		
$\rho(\varepsilon_i, u_i)$			-0.271	-0.339***
Wald χ^2 (15)			2829.86	1984.64
LogL				-3571.32

Note: The table presents estimates of the specification (8). Dependent variable is the change in log value added between 1993 and 2002. IV and TE are instrumental variables and treatment effects estimators, respectively. Robust standard errors are in parentheses. Omitted industry is energy. Definitions of the variables are in the text. *, **, *** significant at 10%, 5%, and 1% respectively. AR is Anderson–Rubin statistic with critical values computed as in Moreira (2003). Critical value for the AR statistic are 3.84 and 5.41 for 5% and 1%, respectively (500 simulations).

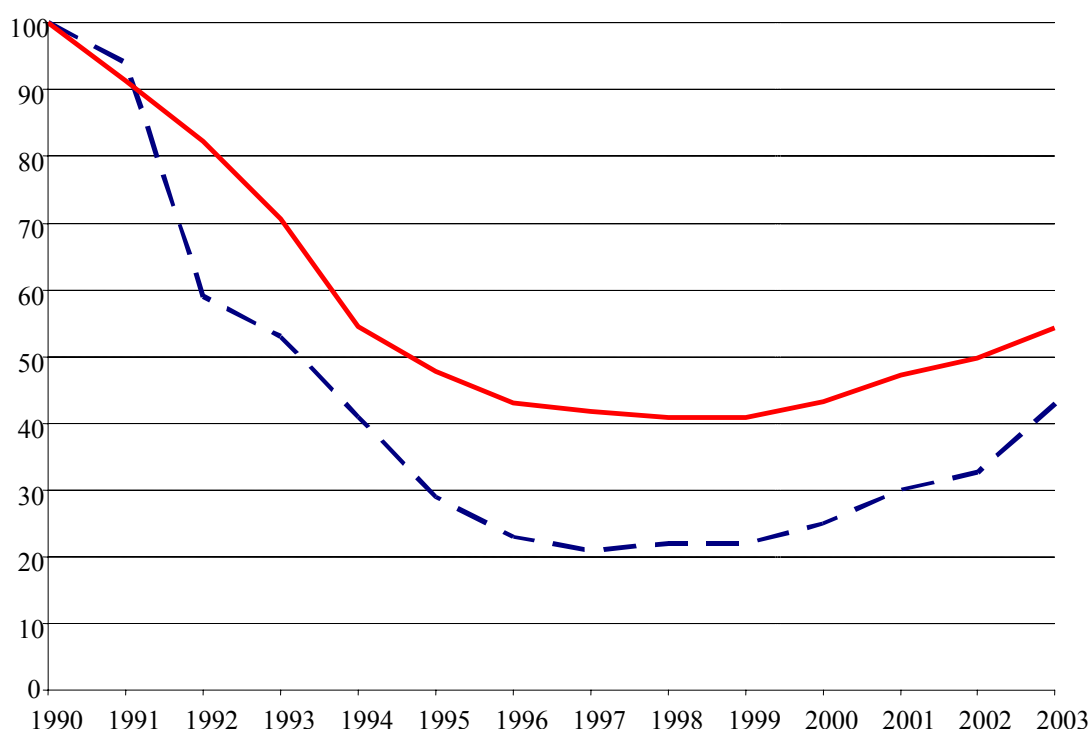


Fig. 1. Indices of gross domestic product, investment and manufacturing. *Note:* solid and broken lines denote gross domestic product and investment, respectively. Investment is in plant, equipment, and structures. Sources: State Statistics Committee of Ukraine, National Bank of Ukraine

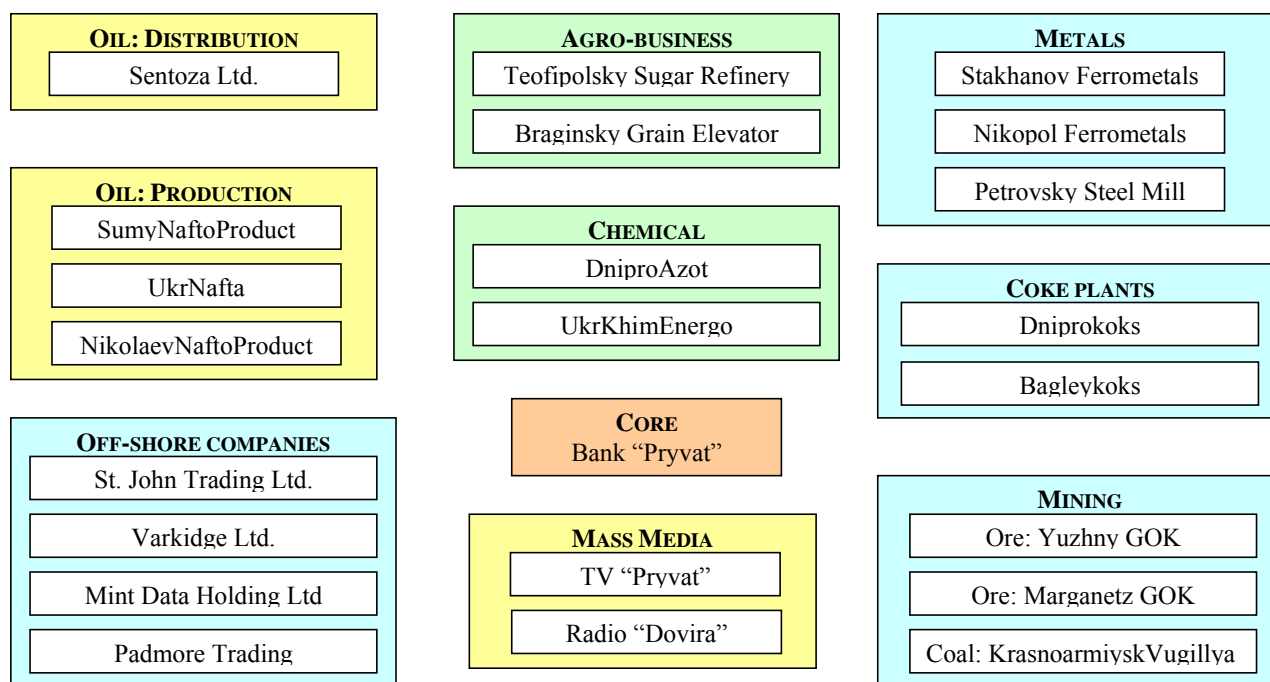


Fig. 2. Simplified corporate structure of oligarchic group "Pryvat". *Note:* adopted from Investgazeta (2003)

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